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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1946.

No. 831

JOSEPH B. FLEMING and AARON COLNON, Trustees of the Estate of The Chicago, Rock Island and Pacific Railway Company, a Corporation,

Petitioners,

vs.

OKLAHOMA TAX COMMISSION,

Respondents.

PETITION FOR REHEARING OF THE PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

W. F. PETERS,
W. V. HODGES,
J. L. GOREE,
JAMES E. GRIGSBY,
EATON ADAMS,
Attorneys for Petitioners, Joseph B. Fleming and Aaron Colnon, Trustees of the Estate of The Chicago, Rock Island and Pacific Railway Company, a corporation.

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PETITION FOR REHEARING OF THE PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioners respectfully pray for a rehearing and reversal of the order hereinbefore entered on the 3rd day of February, 1947, denying the petition for a writ of certiorari to the Circuit Court of Appeals for the Tenth Circuit, and, in support thereof, respectfully show:

Jurisdiction.

The petition for a writ of certiorari in this case was denied on February 3, 1947. This petition for a rehearing thereon is filed within twenty-five days thereafter as provided by No. 33 of the rules of this Court.

GROUNDS.

I.

This Honorable Court may have misapprehended the manner in which the method of taxation approved by the judgment of the Circuit Court of Appeals operates when applied to a railroad company, and hence may have underestimated the importance of a review of that judgment.

The Oklahoma Tax Commission arrived at "Oklahoma Net Taxable Income" by applying to Petitioners'* system net income a ratio which was the arithmetical average of three factors, namely: the percentages which the Oklahoma

Railway Operating Revenues
Railway Operating Expenses
Investment: Fixed Assets

bore to the corresponding items of the entire system. The net result of the use of such a method is that a tax is laid on a fractional part of the Railroad's entire net income regardless of the situs of the property or transactions producing the various items of that income. Manifestly, as system net income increases as a result of strictly non-Oklahoma transactions the amount obtained by applying the average ratio thereto becomes increasingly greater. The fact that such an increase in system net income would tend to lower the Oklahoma revenue ratio factor would not counterbalance or even up the result. This is so for two reasons:

* Sometimes herein called the Railroad.

First: When dealing with such large figures, the base (system revenue) can show considerable increase without materially affecting the ratio. For example, an increace of $100,000 in non-Oklahoma revenue would have decreased the 1941 revenue percentage factor by only .01 per cent. Even if the ratio had been calculated to five decimal .places, the decrease would have been .01032 per cent.

Second: The revenue ratio factor is only one of three, and only one-third of such decrease is reflected in the arithmetical average. Since the Commission carries its ratios to only two decimal places, such $100,000 increase in the system revenue in 1941 would have left the average ratio of 10.62 per cent absolutely unchanged; but the Oklahoma taxable net income would have been increased by $10,620. If the increase had been $200,000, the 10.62 per cent average ratio would still remain unchanged; but Oklahoma would have had $21,240 additional taxable income. If the increase had been $400,00, the average ratio would have fallen to 10.61 per cent; but the Oklahoma portion would have increased by $42,138. The details of the foregoing calculations are shown in the appendix hereto.

In our desire to make the petition for certiorari as brief as possible, we were remiss, perhaps, in not sufficiently illustrating the absurb and unconstitutional conclusions to which the State's formula inevitably leads when applied to an interstate railroad. Let us now give a few examples, in the sincere belief that this Honorable Court may not have fully appreciated how the formula works when applied to a business which is not truly unitary.

If Petitioners' suburban lines, wholly within Illinois and carrying only Chicago commuters, had produced a

million more dollars in net income in 1941, Oklahoma's "fair share and proper proportion" of the entire net income would have been tens of thousands of dollars greater and the tax thereon proportionately larger, even though Oklahoma operations would have contributed absolutely nothing to the production of the additional income. If intrastate freight rates in Iowa had been higher; if there had been more income from checking parcels in Kansas, from station privileges in Tennessee, from serving meals in Arkansas, *Oklahoma* would have benefited. If rich oil fields had been tapped under the Petitioners' right-of-way in *Texas,* it would have been a windfall for *Oklahoma.*

No matter how great may be the deficit in Oklahoma operations, Oklahoma will always collect an income tax if the Railroad as a whole yields any net income. Let us suppose that because of unusually heavy operating expenses in Oklahoma, due to wrecks, floods, state regulatory laws or anything else, the Petitioners had suffered a huge deficit in Oklahoma operations in 1941. In spite of this Oklahoma would have collected an income tax if there had been any system net income; and, ironically, the greater the Oklahoma deficit the larger would have been Oklahoma's share, because the factors producing the deficit would have increased the expense ratio of the formula.

Let us further assume that, because of Oklahoma losses, the Railroad had abandoned all of its operations in Oklahoma except a short stretch of track across the corner of the State, and that there were then no Oklahoma revenues and no Oklahoma fixed assets of more than negligible value. It that event, Oklahoma net taxable income would vary in direct proportion to Oklahoma expenses—a strange, and certainly an unconstitutional,

way for an income tax law to operate. A catastrophic wreck or flood in Oklahoma might then be, like the striking of oil in Texas, a windfall for Oklahoma.

We respectfully submit that the above examples reduce to a constitutional absurdity the State's formula as applied to a railroad operating in several states. It is no answer to say that these things did not occur, or that there was no evidence of them in the record. Under the State's formula, carried to its logical conclusions, they *could* occur; and, what is more important, they differ not in the slightest, except in degree, from that which *did* occur in 1941 and 1942, and that which will always occur as long as Oklahoma is permitted to arrogate to itself for tax purposes a fractional part of the Railroad's entire net income without regard to where the component parts of that net income are actually earned.

The fact that the Commission's method as applied to a railroad can be reduced to an absurdity serves to demonstrate the fundamental error in the Circuit Court of Appeal's judgment; that is, the holding that a railroad is a unitary business in the true sense of the term. We submit that the Circuit Court of Appeals attached undue importance to the mere *physical* unity of Petitioners' railway system. From this standpoint, all the railroads in the United States are a unit, for each is connected with others, and they in turn with still others, so that it is possible to run a train from any point in the United States to any other point therein. Petitioners' line of railway between Chicago and Denver is just as independent of its lines in Oklahoma as is the Burlington line between Chicago and Denver, or the New York Central line between Chicago and New York. If the New York Central and the Petitioners gain large revenues from through traffic moving from origins in New York to

Chicago via the New York Central, and from Chicago to destination at Denver via the Petitioners' lines, have the petitioners' Oklahoma lines contributed any more to Petitioners' share of the revenue than to the New York Central's share? Obviously not; the contribution is the same, precisely nothing. And yet, under the workings of the State's formula, Petitioners' share of the revenue would increase Oklahoma taxable net income and the New York Central's would not.

The Circuit Court of Appeals held that Oklahoma might allocate to itself for income tax purposes a "fair share and proper proportion" of the Petitioners' entire net income. If Oklahoma can do this, so can each of the other thirteen states in which Petitioners' railroad operates; and certainly Oklahoma's idea of a "fair share and proper proportion" is not binding on those other states. The sum total of the portions allocated by the fourteen states might well equal much more than 100 per cent of the system net income without any one state attributing to itself more than a "fair share and proper proportion" of that income, within the Circuit Court of Appeals' conception of that term. We respectfully submit that the constitutional question in this case is not whether Oklahoma laid a tax on a "fair share and proper proportion" of system net income; the question is whether Oklahoma taxed income having an extraterritorial situs.

II.

This Honorable Court may have overlooked the great importance to the administration of state income tax laws of an authoritative decision by this Court on the question as to whether the doctrine of Butler Bros. v. McColgan, in which the tax was on a state franchise and the taxpayer was a wholesaler of dry goods and general merchandise, can be applied constitutionally where the tax is a state tax on net income and the taxpayer is a railroad operating in several states.

The Circuit Court of Appeals apparently ruled this case largely on the authority of *Butler Bros.* v. *McColgan*, 315 U. S. 501; in any event, in holding that Oklahoma might tax a "fair share and proper proportion" of Petitioners' net income it used the constitutional test restated in the *Butler Bros.* case.

Butler Bros. was an Illinois corporation qualified to do business in California. It was engaged in the wholesale dry goods and general merchandise business, having distributing houses in seven states, including one at San Francisco. The tax involved was an annual franchise tax *measured by net income*. According to the books of the San Francisco house, that branch showed a loss for the year in question and, hence, the company felt that it owed only the minimum tax of $25.00. The business as a whole, however, showed a net income and the State fixed the amount of the tax by a method which assigned to the State a "portion of net income reasonably attributable to the business done within this State." The taxpayer did not question the right of the State to levy a tax on its franchise; its position was only that the method of *measuring* that tax operated so as to reach an unconstitutional result. The case obviously differs from the instant case in two important respects:

(A) The tax imposed by California was a tax on the company's franchise, the situs of which was within the State, and was merely measured by net income; the tax involved in the instant case was levied directly upon the Railroad's net income,* many parts of which had an extraterritorial situs.

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* Although the Circuit Court of Appeals did not, of course, question the fact that the tax was, avowedly and by operation and effect, a tax on net income, it implied, perhaps, that the tax was levied only on income earned in Oklahoma when it said (R. 257), "But Oklahoma does not seek to tax property beyond its borders." If that be the implication then the Court's construction of the levying clause is somewhat different from that of the Tax Commission, which has throughout these proceedings contended that the tax was levied on the **entire net income** of the Railroad. The following quotation is from the Commission's brief in the Circuit Court of Appeals; all emphasis is that of the Commission's counsel:

> "An analysis of the Oklahoma income tax statute and its application to this case as uniformly applied by the Oklahoma Tax Commission to all system railroad companies operating in this and other states, may be helpful. Under the Oklahoma Income Tax Law the levying clause (Section 876 (a)) reads in part as follows:
>
> > "'A tax is hereby levied upon every person as defined in Section 874 (b), which shall be collected and paid, for each taxable year, upon and with respect to, the entire net income of such person, which is derived from all property owned and/or business transacted within this State. And a like tax is hereby levied upon every person as defined in Section 874 (b), which tax shall be collected and paid, for each taxable year, upon, and with respect to, the **entire net income** of such person which is derived from all property owned partly within and partly without this State and/or business done partly within and partly without this State (commonly known as interstate business), **such income** derived from property owned partly within and partly without this State and/or from business transacted partly within and partly without this State, upon which said tax is hereby levied, to be determined or allocated under the formula or formulae as provided in Section 878 of this Act. * * *'"
>
> "The portion of the levying clause quoted above deals with two kinds of income: First, the net income derived from all property owned and/or business transacted within

In franchise tax cases the question is ***how much*** can the State charge for the privilege of doing business within its borders; and the answer is ***any amount*** as long as it is reasonable and non-discriminatory, (unless, of course, the "franchise tax" is a direct tax on extraterritorial values, in disguise). In income tax cases the question is *what parts* of entire net income can be taxed; and the answer is *only those parts having their situs within the taxing State.* In franchise tax cases the direct taxability of particular items of income is immaterial; in income tax cases the reasonableness, the fairness, or the justness of the amounts of income credited to the State is, in itself, immaterial.

The distinction just drawn was recognized by this Court as late as January 6, 1947, when it handed down its opinion in *International Harvester Co.* v. *Evatt* (sheet opinion No. 75—October Term, 1946), a franchise tax case. The Court said on page 5 that:

> "Plainly Ohio sought to tax only what she was entitled to tax, and there is nothing about application of the formula in this case that indicates a potentially unfair result under any circumstances. It is not even contended here that the amount of these taxes could be considered to bear an unjust or improper relation to the value of the privilege of doing business in Ohio if the legislature had imposed a flat franchise tax of the same amounts for the respective years which application of this formula has produced."

Oklahoma; second, the net income derived from all property owned partly within and partly without the State of Oklahoma and/or business done partly within and partly without this State. The **net income** to be taxed by Oklahoma must by the levying clause be determined or allocated under the formula or formulae in Section 878. The only place where a formula is mentioned is in subsection (g) of Section 878."

The Court said concerning formulas for *measuring* taxes: (Page 6)

> "Rough approximation rather than precision is sufficient."

Would the Court say the same with respect to the *selection* of objects of taxation? We believe not.

We have mentioned hereinabove the possibility of having to pay state income taxes on more than 100% of entire net income under the doctrine announced by the Circuit Court of Appeals. With respect to this possibility, can it reasonably be said that the following quotation from the *International Harvester Company* case is in point?

> "Since [the annual franchise tax] is assessed only against the privilege of doing local Ohio business of manufacturing and selling, we do not come to the question, argued by the appellant, of possible multiplication of this tax by reason of its imposition by other states. None of them can tax the privilege of operating factories and sales agencies in Ohio." (Page 6)

This quotation from a franchise tax case reveals most pointedly the inapplicability of the principles which govern such cases to cases such as that at bar.

The basic distinction between the two types of cases was emphasized again and again by this Court in the opinion in *Educational Films Corp.* v. *Ward,* 282 U. S. 379, wherein it was held that a State franchise tax was not invalid because *measured* by net income which included income exempt from taxation under the Federal Constitution. Mr. Justice Stone stated, among other things, *l. c.* 389:

"The precise question now presented was definitely answered in *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 162, *et seq.*, which upheld a federal tax, levied upon a corporate franchise granted by a state, but measured by the entire corporate income, including, in that case, income from tax exempt municipal bonds. In reaching this conclusion, the Court reaffirmed the distinction, repeatedly made in earlier decisions, between a tax, invalid because laid directly on governmental instrumentalities or income derived from them, and on excise which is valid because imposed on corporate franchises, even though the corporate property or income which is the measure of the tax embraces tax exempt securities or their income."

Also, *l. c.* 391:

"* * * * there is a logical and practical distinction between a tax laid directly upon all of any class of government instrumentalities, which the Constitution impliedly forbids, and a tax such as the present which can in no case have any incidence, unless the taxpayer enjoys a privilege which is a proper object of taxation and which would not be open to question if its amount were arrived at by any other non-discriminatory method."

Concerning a case where the tax was aimed directly at exempt income, the Court said *l. c.* 392:

"The case was thus brought within the purview of *Miller* v. *Milwaukee,* 272 U. S. 713, in which this Court had stated, with respect to a state tax on income, no franchise or privilege tax being involved (p. 715): 'If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same

> result, the statute must fail even if but for its purpose or special operation it would be perfectly good.' "

See also *Commonwealth* v. *Ford Motor Co.*, 350 Pa. 236, 38 A. (2) 329; appeal dismissed, *Ford Motor Co.* v. *Pennsylvania*, 324 U. S. 827, a case where the formula for ***measuring*** a franchise tax operated upon property which had an extraterritorial situs and which was, concededly, immune to direct taxation under the Fourteenth Amendment to the Federal Constitution.

(B) The business of Butler Bros. was truly unitary; Petitioners' is not.

Even if the tax involved in *Butler Bros.* v. *McColgan*, had been laid directly on net income the case would not be in point because of the material distinction between that company's business and the Petitioners'. Butler Bros was a true unitary business; the source of its profits was its central buying division. It was admitted that more favorable prices were obtained by centralized buying of merchandise in great volume than would have been obtained if the purchases were separately made for the account of any one branch. Thus potential profits accrued to the company at the very outset, when the merchandise was *purchased,* even though they were not realized until the merchandise was sold through the various outlets set up for that purpose. Manifestly, the business of the San Francisco house, in augmenting the volume of purchases, contributed to those profits, even though its books showed a local loss, just as surely as did the other branches whose books showed a local gain.

The business of manufacturing and selling typewriters in which the taxpayer in *Underwood Typewriter Co.* v. *Chamberlain,* 254 U. S. 113, was engaged was also a

truly unitary business. In every step of the process by which the typewriters were manufactured, distributed, and sold there was a potential gain, even though, in all stages except the final one, it was an incomputable and unrealizable gain. When the process reached fruition it was only just, as this Court held, that Connecticut, where the machines were manufactured, should be credited with what was, so far as the evidence showed, an appropriate share of the company's entire net income; for, whereever that income was *received,* it constituted merely the materialization of gains accumulated over the entire process.

But does the same reasoning apply to the instant case? Can it justify Oklahoma in crediting itself with earnings derived from *transportation services* rendered entirely outside of the State, services which would have been performed, and from which Petitioners would have derived just as much revenue, if there hadn't been a railroad line in Oklahoma? Do Petitioners' Oklahoma lines bear the same relation to the revenue from a shipment of freight from Chicago to Rock Island, Illinois, that the Underwood Typewriter Company's factory in Connecticut bore to the proceeds of the sale in New York of a typewriter made in that factory? Surely not; for the railroad business bears not the slightest resemblance to that of Underwood Typewriter Company, or Butler Bros., in any material respect. Petitioners sell *transportation services* and their trains manufacture it in its entirety as they go. By very definition, "transportation service" connotes *situs;* and, hence, to permit Oklahoma to allocate to itself income derived from transportation services performed without the State is to deny the undeniable constitutional principle that situs is a decisive factor in defining state taxing power.

III.

This Honorable Court may have overlooked the underlying conflict between the Circuit Court of Appeals' decision and local law.

One of Petitioners' principal points is that subsection (g), Section 878 of Title 68, Oklahoma Statutes, 1941, which prescribes the formula used by the Tax Commission, is not applicable by its terms to Petitioners' business. The question raised thereby is one of statutory construction, and should, of course, be decided according to local law. We submit that the Circuit Court of Appeals did not so decide it; and we respectfully suggest that this Court may have overlooked the respects in which the decision of the Court of Appeals is probably in conflict with Oklahoma statutes and with a decision of the Supreme Court of the State.

(A) By the express terms of the Oklahoma income tax statutes petitioners' business is not unitary.

The keystone of the Court's decision on the issue of statutory construction was its holding that the railroad was a unitary business. This holding was made on authority of *Butler Bros., supra,* in the face of the explicit definition contained in subsection (g), that a unitary business is "a single business enterprise, all the factors of which enterprise are essential to the realization of an ultimate gain derived from the enterprise as a whole." For the reasons elsewhere mentioned this definition does not fit a railroad, whatever may be said as to definitions of "unitary" contained in Federal decisions.

(B) Under the authority of Magnolia Petroleum Company v. Oklahoma Tax Commission, 190 Okl. 172, 121 Pac. (2d) 1008, direct allocation of income is entitled to first consideration.

In the *Magnolia* Case the controversy involved income credited to the crude purchasing and storage department of the taxpayer. This "department" was merely a creature of the company's system of books and accounts; but in spite of this fact, and the further fact that the company's business was unitary, the Supreme Court of Oklahoma held that direct allocation was entitled to preference over the formula method. The doctrine of the *Magnolia* Case is applicable, *a fortiori*, to the facts of the instant case.

CONCLUSION.

The consequences of the decision of the Circuit Court of Appeals will be far reaching and grave if allowed to stand. Notwithstanding this Court's frequent admonition that a denial of a petition for certiorari is not to be deemed an affirmance of the judgment below, that decision will be widely if not universally followed. There are from 150 to 200 interstate railroads operating in the United States; there are twenty-four States which have income tax laws applying to railroads, and it is safe to assume that there is agitation in most of the other States to adopt similar laws. We respectfully suggest that this Honorable Court should state whether or not every State may lay a tax on what it conceives to be its "fair share and proper proportion" of the net income of every railroad doing any business within its borders.

Wherefore, upon the foregoing grounds, it is respectfully urged that this petition for rehearing be granted; that the order denying the petition for a writ of certiorari be vacated; and that, upon further consideration, the petition for a writ of certiorari be granted.

We hereby certify that the foregoing petition is presented in good faith and not for delay.

Respectfully submitted,

W. F. Peter,
Eaton Adams,
1025 LaSalle Street Station,
Chicago, Illinois.

W. V. Hodges,
J. L. Goree,
947 Equitable Bldg.,
Denver, Colorado.

James E. Grigsby,
1350 First National Bldg.,
Oklahoma City, Oklahoma.

Attorneys for Petitioners, Joseph B. Fleming and Aaron Colnon, Trustees of the Estate of The Chicago, Rock Island and Pacific Railway Company, a corporation.

APPENDIX

17.

	Total	Okla.	Year 1941 Ratio	Per Cent on Increased Revenue of $100,000	Per Cent on Increased Revenue of $200,000	Per Cent on Increased Revenue of $300,000	Per Cent on Increased Revenue of $400,000
Ry. Oper. Revenue	$ 96,962,498.74[1]	$ 9,714,126.93[1]	10.02	10.01	10.00	9.99	9.98
Ry. Oper. Expenses	69,105,056.76[1]	7,057,222.00[1]	10.21	10.21	10.21	10.21	10.21
Investment	345,895,297.00[1]	40,274,660.00[1]	11.64	11.64	11.64	11.64	11.64
			31.87	31.86	31.85	31.84	31.83
		Average	10.62%	10.62%	10.62%	10.61%	10.61%
System Net Income			$3,017,407.52[2]	$3,117,407.58	$3,217,407.58	$3,317,407.58	$3,417,407.58
Per Cent			10.62[2]	10.62	10.62	10.61	10.61
Oklahoma adjusted Net Taxable Income			$ 320,448.68[2]	$ 331,068.68	$ 341,688.68	$ 351,976.94	$ 362,586.94

Note: "Increased revenue" means revenue from transactions wholly outside of Oklahoma.

Note 1: See "Basis of Prorating Income to Oklahoma" on attachment to Stipulation of Facts (R. 21, 139).

Note 2: See Exhibit 14 (R. 142).